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# Office of Thrift Supervision

## Regulatory Bulletin 21

### Servicing Contracts

**November 22, 1989**

***Summary:***

To notify the District examinations staff of the need to review contracts for EDP and other vital services during safety and soundness/compliance examinations.

***For Further Information Contact:***

The Office of Thrift Supervision for the District in which you are located or the Division of Compliance Programs, Office of Thrift Supervision, Washington, D.C.

**Background**

Recently, financial institutions (banks, thrifts, credit unions) have been entering into fixed-priced, long-term servicing contracts which could ultimately have an adverse effect on the institution. In some instances service bureaus have offered certain inducements to the institutions as an incentive to convert to the service bureau. Examples of these inducements include offers:

- To purchase the institution's existing data processing equipment at book value, which substantially exceeds its current market value;
- To purchase other assets from the institution (e.g., real estate owned) at book value, which may exceed current market value;
- To provide capital by purchasing stock from the institution;
- To provide "cash advances" to the institution once the conversion process is complete; and
- To defer expense recognition of conversion costs or processing fees under the terms of lease or licensing contracts.

Generally, these inducements represent an attempt by the institution to maintain capital by deferring losses on the disposition of assets or avoiding expense recognition for current charges. As such, the institution's treatment typically is inconsistent with generally accepted accounting principles (GAAP) and the OTS quarterly report instructions.

Until recently, EDP servicing contracts usually have been written based on a pricing structure tied to the number of accounts and items processed. Contract terms were normally one to three years in length and provided reasonable means for cancellation. Some contracts are now being written with terms of up to ten years in length which are based on a fixed price, regardless of volume. These contracts usually provide for a significant increase in costs after the first few years and contain substantial cancellation penalties, especially if the original proposal involved the purchase of equipment and/or the transfer of personnel from the institution to the service bureau. Additionally, if the institution is unable to increase volume in proportion to the increase in annual service fees, the fees may become a substantial drain on the earnings of the institution.

Examiners should pay particular attention to these contracts to insure that the institutions have not entered into agreements with severe penalties that make switching to another service bureau or back

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to in-house processing a non-viable alternative, even at the expiration of the contract.

Examiners should also assure themselves that the service bureau is providing for a level of service that meets both the present and the long-term needs of the institution. With the rapid changes occurring in EDP technology, it would appear difficult to project the EDP needs of any institution for a ten-year period.

### **Examination Considerations**

Examiners should review all arrangements between a provider of vital services and the institution. The review should include the servicer's proposal and contracts. A determination should be made as to the extent to which the institution obtained proposals from other servicers and the evaluation process the institution utilized in making its selection. The examiner should be aware that frequently the servicer's proposal to the institution will stress advantages that the institution will realize from the contract while not mentioning any disadvantages. In many instances, the institution is focusing on short-term benefits and does not fully weigh the long-term costs of the contracts.

Examiners are especially reminded to scrutinize any loan or other transaction involving the servicer. This includes loans to the servicer which are written at unusually favorable terms, such as non-interest bearing loans and loans which are not enforceable if the contract is terminated or the institution is closed by regulatory authorities. The examiner also should review any significant deposit accounts maintained by the servicer. Any transaction involving the transfer of assets of questionable value from the institution to the servicer at an inflated value (usually book value) also should be investigated.

While many areas that the examiner should be aware of have been indicated, these are only guidelines. The vehicle employed by the servicer and institution may vary from case-to-case. However, the one consistent factor in these transactions is that they are favorable to the servicer, but may not be in the overall best interest of the institution.

### **Financial Institutions Reform, Recovery, And Enforcement Act of 1989 (FIRREA) Implications**

Section 225 of FIRREA amends the Federal Deposit Insurance Act (FDIA), adding Section 30 which includes the following provision:

- (a) In General. An insured depository institution may not enter into a written or oral contract with any person to provide goods, products, or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution.

Action to enforce compliance with this section may be taken under Section 8 of FDIA, and may include a requirement that the depository institution properly reflect the transaction on its books. Section 8 of FDIA provides the Federal banking agencies with the authority to issue cease-and-desist orders to ensure that depository institutions discontinue unsafe and unsound operating practices. Section 902 of FIRREA expands the authority of FDIA to include savings association affiliates and entities.

/s/Jonathan L. Fiechter  
Senior Deputy Director Supervision Policy

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## **Office of Thrift Supervision**

### **Thrift Bulletin 11**

#### **Large Scale Integrated Software System (LSIS) Control Guidelines**

**December 9, 1988**

***Summary:***

The purpose of this policy statement is to alert financial institutions to the risks associated with these sophisticated software systems and to identify the responsibilities of management when acquiring, developing, and using such systems. Management in each insured institution utilizing Large Scale Integrated Financial Software Systems should implement controls consistent with guidelines in this Bulletin.

***For Further Information Contact:***

The FHLBank District in which you are located or the Compliance Programs Division of the Office of Regulatory Activities, Federal Home Loan Bank System, Washington, DC.

/s/Darrel W. Dochow  
Executive Director

See FFIEC Policies SP-4 for details.

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# Office of Thrift Supervision

## Thrift Bulletin 11-1

### Purchased Software Evaluation Guidelines

**April 20, 1988**

***Summary:***

This Bulletin alerts the board of directors and management of thrift institutions to potential risks and control issues in purchasing vendor software. It provides general guidelines for evaluating vendor software packages prior to their acquisition.

***For Further Information Contact:***

The FHLBank District in which you are located or the Compliance Programs Division of the Office of Regulatory Activities, Federal Home Loan Bank System, Washington, DC.

**Background/Concerns**

In recent years, there has been an increase in the number of companies developing and marketing software systems to meet the data processing and information needs of the thrift industry. Software packages can be obtained from a variety of sources such as large EDP system manufactures, software vendors, and accounting firms.

There are potential risks and control issues that should be addressed when institutions consider the purchase of software systems. Some institutions have found that software does not work as expected, is not adequately supported by the vendor, or requires costly changes in existing data processing systems that were not identified prior to purchasing the software. These situations can occur if the institution lacks management guidelines for evaluating software packages or if it does not have the expertise to perform these evaluations.

For example, poorly defined user requirements may result in the selection of software that does not meet the needs of the institution, or a weak cost-benefits analysis may not identify all direct and indirect costs of installing a software package. In other cases, an ineffective financial analysis may fail to evaluate the capability of the company to support the software after installation. As a result of these and other weaknesses, institutions can incur significant costs for software or hardware modifications that were not considered or brought to light in the evaluation process. In some instances, institutions have elected not to implement newly purchased software, resulting in a monetary loss to the institution.

**Policy**

The board of directors and management are responsible for ensuring that policies and procedures are in place and that resources are available to properly evaluate the risks and control issues of purchased software and vendor companies prior to purchase.

**Guidelines**

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The following guidelines are provided to assist the board of directors and management in evaluating software packages and vendor companies prior to purchasing software. They are recommended for significant software purchases or when the software will support critical aspects of the institution's operations. These guidelines identify the type of studies or analyses that should generally be performed to improve the evaluation process and reduce the risk of the software not meeting the needs of the institution. In cases where there are limited alternatives for purchasing software such as single vendor applications, or operating system software designed for selected manufacturer's hardware, portions of the guidelines may not be applicable.

### **User Requirements Analysis**

It is generally appropriate to analyze user requirements before evaluating vendor software packages. This analysis should usually define the business reason for purchasing software, deficiencies of the current system, user and data processing requirements, user and management reporting requirements, system interfaces to other systems, and the in-house resources needed to install and maintain the system. User, Data Processing, and the Audit Departments should generally be involved in this analysis. The resulting document will provide a basis for evaluating vendor software packages.

### **Cost-Benefit Study**

After the user requirements analysis is completed, the direct and indirect costs of installing and maintaining purchased software should be compared to other business alternatives such as the use of service bureaus, modifications to existing applications, or manual systems. The capabilities and costs of each alternative should be analyzed and compared in a common format. The purchased software alternative should include the costs of modifications to existing data processing systems and expected return on investment.

If the results of the user requirements analysis and cost-benefit study indicate purchased software is cost-effective and the preferred solution, the following factors should be evaluated.

### **Financial Stability of the Company**

The financial statements and resources of the software company should be analyzed to determine if the company is financially sound and has the resources to support and maintain the software package during its estimated life span. This analysis is especially important if the vendor is responsible for future modifications to the software programs. In these cases, procedures should be established to analyze the financial statements, performance, and stability of the company on an annual basis.

### **Contract Review**

The software company's contract should be carefully reviewed by appropriate management and legal personnel to identify potential risks for the institution. This review should identify the contract deliverables, scheduled delivery dates, method of delivery, documentation, and other key contract terms. It should also include the obligations of the software company to support the software after purchase, furnish updates, and arrange for supplying the program source code and documentation if the software company goes out of business. The provisions for terminating or extending the contract should be clearly spelled out. Recourse for monetary losses as a direct result of errors in the software should also be considered. Requirements for annual financial information, preferably audited, should be incorporated into the contract.

Institutions making a substantial investment in new software should consider including in the contract the right of internal audit staff and FHLB examiners to perform examinations of the software companies for risk and control issues relating to the software purchase.

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## **User References**

User references are an important source of information in evaluating vendor packages. A user reference list of other institutions using the software package should be obtained from the vendor. These companies should be contacted to obtain information such as the software package purchased, the computer system used to run the software, modifications that were made after installation, the length of time in use, the quality of vendor conversion support, performance on similar hardware, and other pertinent information.

On-site visits to other institutions that have installed the software on a similar computer system should be considered before making a substantial investment in a software package. Care should also be taken in purchasing software that has not been installed and thoroughly tested in other locations.

## **Audit and Security Considerations**

The software package should be reviewed for security controls and audit trails such as access to data files, authorizations, password controls, data access logs, reporting of security violations, and capabilities of utility programs to alter data.

## **Life Span of the Product**

The age of the software, the number of updates issued since it was developed, the software vendor's plans for future modifications, and the useful life of the package should be evaluated against the institution's short-and long-term business plans.

## **Documentation**

The documentation and manuals provided with the software package, and on-line help programs if the system is interactive, should be carefully reviewed by Data Processing and User Departments for content, readability, and completeness. This review should include input forms and output reports, compliance with in-house standards, and documentation provided with modifications.

## **Testing**

Vendors should test all parts of the system in a systematic manner. Information on the testing procedures performed by the vendor should be obtained and evaluated. This information should include test plans, the hardware used for testing, and the method used to verify that the software calculations meet regulatory requirements, e.g., Truth In Lending disclosure calculations.

## **Conversion Assistance**

The background and experience level of software company personnel assisting the institution in conversion planning, support, and training activities should be obtained and evaluated. The vendor should provide a detailed schedule of pre- and post-conversion support activities with associated costs. Conversion support materials should be carefully reviewed for quality, readability and completeness. The software company internal resources required to support conversion training should also be evaluated. The quality of conversion support provided by the vendor should be verified when checking user references.

## **Maintenance Support**

The capability of the vendor company to provide timely, on-going maintenance support for user



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programming requests, product updates and regulatory changes should be evaluated. The content, frequency and costs of previously issued software updates should be reviewed. The software should also be evaluated for report-writing capabilities that permit in-house personnel to produce new or specialized reports for management, user departments, or to comply with regulatory requirements. If vendor programming is required for report modifications, these costs should be considered in the evaluation.

### **Software Installation**

After evaluation and selection of a software package that meets the needs of the institution, the software contract should be approved by senior management. Management should provide for an effective project control system to facilitate planning and implementation of the software. Liaison personnel should also be designated to manage the vendor relationship and coordinate the software installation.

/s/Darrel W. Dochow  
Executive Director

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# Office of Thrift Supervision

## Thrift Bulletin 29

### End-User Computing

**July 10, 1989**

***Summary:***

This Bulletin supersedes R67-1 which is hereby rescinded. The contents have not changed. This Bulletin is meant to provide guidance to management for evaluating potential risks, and for implementing adequate control practices and responsibilities in end-user computing environments. It is expected that management in each insured institution utilizing end-user computer systems will implement controls consistent with guidelines offered in this Bulletin.

***For Further Information Contact:***

The FHLBank District in which you are located or the Compliance Programs Division of the Office of Regulatory Activities, Federal Home Loan Bank System, Washington, DC.

/s/Darrel W. Dochow  
Executive Director

See FFIEC Policies SP-3 for details.

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## Office of Thrift Supervision

### Thrift Bulletin 30

#### Interagency Policy on Contingency Planning for Financial Institutions

July 19, 1989

*Summary:*

This Bulletin supersedes R 67 which is hereby rescinded. It updates R 67 to require institution-wide contingency planning as opposed to focusing on centralized computer operations. It is expected that management of each financial institution will implement policies consistent with this Bulletin.

*For Further Information Contact:*

The FHLBank District in which you are located or the Compliance Programs Division of the Office of Regulatory Activities, Federal Home Loan Bank System, Washington, DC.

/s/Darrel W. Dochow  
Executive Director

See FFIEC Policies SP-5 for details.

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## Office of Thrift Supervision

### Thrift Bulletin 44

#### Interagency Statement on EDP Service Contracts

February 7, 1990

***Summary:***

The Office of Thrift Supervision, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and the National Credit Union Administration have jointly issued the attached interagency statement on EDP Service Contracts to all federally supervised financial institutions. The statement alerts financial institutions to potential risks in contracting for EDP services and/or failing to properly account for certain contract provisions.

***For Further Information Contact:***

Your District office or the Division of Compliance Programs, Office of Thrift Supervision, Washington, D.C.

/s/Jonathan L. Fiechter  
Senior Deputy Director  
Supervision Policy

See FFIEC Policies SP-6 for details

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# **Office of Thrift Supervision**

## **Thrift Bulletin 46**

### **Contracting for Data Processing Services or Systems**

**May 1, 1990**

***Summary:***

This Bulletin supersedes R-13a which is hereby rescinded. This Bulletin has been amended to reference the pertinent sections of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). A provision also has been added recommending that an institution's legal counsel review EDP contracts prior to ratification. Finally, a provision has been added relating to contracting for EDP services, under which EDP vendors agree to submit to examination by the Office of Thrift Supervision (OTS).

***For Further Information Contact:***

Your District office or Compliance Programs, Office of Thrift Supervision, Washington, D.C.

**Background**

Data processing activities have become essential to the efficient delivery of customer services and to the operation of most thrift institutions. Recent trends indicate that thrift institutions are finding data processing service organizations to be a cost effective alternative for many of their data processing needs rather than relying solely on in-house computer systems.

The provision of EDP services to financial institutions by service organizations entails certain risks and responsibilities. Contracts for EDP services and systems should appropriately define and balance those risks and responsibilities between the vendor and the institution.

***Policy***

Thrift institution management should carefully review any proposed data processing service contracts or agreements to minimize the institution's exposure to risk, and should follow the guidelines listed below prior to signing any contracts with vendors of EDP services. Furthermore, the institution's legal counsel should review the draft contract to determine that the interests of the financial institution are adequately protected.

**Guidelines**

1. Consider the following points prior to entering into any EDP-related service arrangement:
  - Alternative vendors and related costs;
  - Financial stability of the vendor;
  - Requirements for termination of service; and
  - Quality of service provided.
2. Ensure that any contract specifies the duties and responsibilities of the financial institution and the vendor of EDP services.
3. Review the contract's penalty provisions for reasonableness in the areas of: length of

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contract, excessive fees, compensation of the servicer for loss of income, etc.

4. Ensure that the following items are included in the service contracts:

- The vendor agrees to submit to an examination by OTS, which will evaluate and monitor the soundness of the vendor in order to limit the institution's risk. The following language should be incorporated in the contract:

"By entering into this agreement the EDP services vendor agrees that the Office of Thrift Supervision will have the authority and responsibility provided to the other regulatory agencies pursuant to the Bank Service Corporation Act, 12 U.S.C. 1867(C) relating to services performed by contract or otherwise."

- The vendor provides the OTS District Director of the district in which the data processing center is located with a copy of the current third party review report when a review has been performed. (See PA-7-1A for guidance concerning third party review report requirements.)
- The vendor provides the OTS District Director of the district in which the data processing center is located with a copy of the vendor's current audited financial statements.
- The vendor agrees to release the information necessary to allow the institution to develop a disaster contingency plan which will work in concert with the vendor's plan.

In addition, institutions should be aware of the FIRREA-imposed restrictions on contracts as outlined in Thrift Bulletin 44, "Interagency Statement on EDP Service Contracts." Also, the provisions of 12 C.F.R. 563.17-1(d) and (e) outline reporting requirements for an institution that elects to maintain any of its records by means of data processing servicers.

The attachment to this Bulletin provides further guidelines for a thrift institution initiating, renewing, or revising a contract or agreement for EDP services.

/s/John F. Downey  
Acting Senior Deputy  
Director for Supervision

Attachment

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## Attachment to TB 46

### Contracting for Data Processing Services or Systems

While the provisions in an EDP service contract are not standardized across the industry, a number of items are included in most contracts. This attachment contains a list of various provisions which are usually incorporated in EDP servicing contracts. Neither the significant deviation from, or inclusion of, these items will render a contract unacceptable or acceptable. This is an outline and is not meant to be all inclusive.

Provisions contained in an electronic data processing servicing contract may include:

- A detailed description of the specific work to be performed by the servicer, and the frequency and general content of the related reports.
- A fee schedule which outlines development, conversion and processing cost, as well as charges for special requests.
- An outline of the training to be provided for institution personnel, including the type, number of employees to be trained, and the associated cost.
- Established time schedules for receipt and delivery of work.
- The availability of on-line communications, security over accesses and transmissions, and alternate data entry considerations.
- Audit responsibility, including the right of financial institution representatives to perform an audit.
- A definition of backup, contingency, and record protection provisions (equipment, software and data files) to ensure timely processing by the service center in the event of an emergency.
- A detailed description of liability for source documents while in transit to and from the service center. The responsible party should maintain adequate insurance coverage for such liabilities.
- Maintenance of adequate insurance for fidelity and fire liability, reconstruction of physical properties, data reconstruction, and resumption of normal operations, as well as for data losses from errors and omissions.
- Confidentiality of records.
- Ownership of software and related documentation.
- Ownership of master and transaction data files and their return in machine-readable format upon the termination of the contract or agreement.
- Price changes, cost and method of cancellation of the contract, or withdrawal from the servicing arrangement by either party.

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- Processing priorities for both normal and emergency situations.
  - Mandatory notification by the servicer of all systems changes that affect the institution.
  - A requirement that the vendor be responsible for keeping the software current by incorporating regulatory changes and updates.
  - Access to vendor's source code and maintenance of documentation via escrow agreements for turnkey operations.
  - A guarantee that the servicer will provide necessary levels of transition assistance if the institution decides to convert to other automation alternatives.
  - Cancellation, termination, and bankruptcy clauses.
  - A requirement that the EFT facility provide for contingencies, integrity, security, and confidentiality of data.
  - Financial information (audited) to be provided annually by the servicer to the financial institution.
  - A detailed description of the disaster recovery contingency test results to be provided annually by the servicer to the financial institution.
  - A prohibition against the assignment of the contract by either party without the consent of the other.



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## Office of Thrift Supervision

### Thrift Bulletin 59

#### Interagency Supervisory Statement on EFT Switches and Network Services

May 19, 1993

*Summary:*

The Office of Thrift Supervision, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and the National Credit Union Administration have jointly issued the attached Interagency Supervisory Statement on EFT Switches and Network Services to all federally supervised financial institutions. The statement alerts the board of directors and senior management of financial institutions to the risks associated with switch and network services in electronic funds transfer (EFT) systems. Management of each institution that uses EFT switches and network services should implement policies consistent with this bulletin.

*For Further Information Contact:*

Your Regional office or the Division of Compliance Programs, Office of Thrift Supervision, Washington, D.C.

/s/John F. Robinson  
Acting Deputy Director for Washington Operations

See FFIEC Policies SP-9 for details.